

STATE OF WASHINGTON
DEPARTMENT OF LABOR AND INDUSTRIES
INDUSTRIAL INSURANCE FUND

FINANCIAL INFORMATION
(UNAUDITED)

For the following funds:
608 - Accident Fund
609 - Medical Aid Fund
610 - Accident Reserve Fund

As of June 30, 2001

Prepared by: Insurance Services Division

10/22/01
State of Washington

**Department of Labor and Industries
Industrial Insurance Fund**

**Management's Discussion and
Analysis of Results of Operations
and Financial Condition**

Cash Flow from Operations

The Industrial Insurance Fund (the Fund) administers the Workers' Compensation Insurance program in the state of Washington. Workers' Compensation benefits are paid for lost wages during disability, permanent partial and total disability, vocational rehabilitation and medical costs incurred in conjunction with the injury. Benefits are funded by premiums paid by employers and employees who are not self-insured and earnings of the Fund's investment portfolio.

Premiums collected during the 12 month period ending June 30, 2001 were \$896 million, a drop of \$36 million, nearly four percent over the prior 12 months. Rate decreases in 1999 and 2000 accounted for \$28 million of that drop. Exposure grew at the slowest annual pace in nine years, with quarterly exposure change near zero. Premium volumes will continue to decline if the exposure growth rate remains low.

Benefits paid were \$1 billion for the 12 month period ending June 30, 2001. This is 7.0% more than was paid in the 12 month period ending June 30, 2000. Quarterly benefits paid were \$270 million. This is 4.3% greater than the quarter ending June 30, 2000. Much of the growth in benefit payments is coming from the Medical Aid Fund. The Pension Fund payments are also growing rapidly, 13.7% in the latest fiscal year.

Cash flow from investment income (primarily interest) was \$133 million for the quarter and \$541 million in the latest 12 months. This is a 5.4% increase on an annual basis.

Financial Condition

Total assets increased by \$43 million in the quarter to end at \$8.71 billion. The \$8.71 billion is a decrease of \$210 million, or 2.4% since 6/30/00. The contingency reserve did not change in the quarter. Stock market developments were favorable for the quarter. The market value of equities held increased by \$67 million. The ending contingency reserve of \$1.2 billion was 16.9% of benefit and claim administration liabilities. Annual net earned premiums

declined slightly due to rate reductions. Net annual retrospective return premiums decreased by \$57 million from 6/30/00 to 6/30/01, masking the reduction to net earned premiums. The reduction in retrospective return premiums is a result of the shrinking difference in loss experience between retro and non-retro policies.

Reserves

Total benefit reserves increased by \$72 million in the quarter. The Accident Fund reserves increased by \$84 million, the Medical Aid Fund reserves decreased by \$64 million and the Pension Fund reserves increased by \$52 million. Accident Fund reserves generated adverse runoff of \$87 million, driven by development on hearing loss claims, emerging case law on the Cockle decision and offset somewhat by beneficial developments in Timeloss and TPD benefit reserves as the expected long term increase in timeloss duration was reduced to 2.5% from 3.0%. The Medical Aid Fund had beneficial loss reserve development of \$114 million during the quarter.

There were 359 TPD pensions granted in the quarter and 1,166 TPD pensions were granted in the year ending 6/30/01. That's 164 pensions or 16% more than were granted in the year ending 6/30/00.

The Claim Administration reserves increased proportionally with the increase to benefit reserves. The retrospective premium refund reserve decreased \$46 million in the quarter and \$13 million compared to 6/30/00. This 9.8% annual reduction in net retrospective return premiums is indicative of the expectation that future return premiums will be less than seen in prior years.

Liquidity and Capital Resources

The Fund's operation requires liquidity sufficient to meet both short-term and long-term requirements. Short-term liquidity requirements come from three basic elements. First, dividends and large retrospective premium returns require an increased degree of liquidity. Second, benefit payment and investment operations are sensitive to variations in premium adequacy. Finally, workers' compensation claims are subject to some variation, usually inflationary.

The Fund has generally met its operating requirements by maintaining appropriate levels of liquidity in its investment portfolio and through utilization of positive cash flow. This has allowed the Fund to minimize trading activity, maintain a stable investment portfolio, and provide a sound basis for adequate Reserves for Estimated Future Benefits.

The Washington State Investment Board and the Washington State Treasurer manage the Fund's investment portfolio. The portfolio is managed to balance cash flow, timing and reinvestment risks, and then maximize current income while preserving capital. Currently, the Fund has the financial capability to hold its fixed-income portfolio to maturity, and to match projected cash inflows from premiums and investment income from this portfolio with projected cash outflows for payment of benefits. All currently held fixed-income securities were rated Investment Grade when purchased. All foreign fixed-income securities are dollar-denominated; therefore there is no foreign currency fluctuation exposure.

All equity holdings are in the form of index funds. The Barclay-Wilshire 5000 equity fund (BGI) was designed to be nearly equivalent to the Wilshire 5000. There may be some small tracking error from period to period when comparing to the true Wilshire 5000, as the matching is not exact. The Wilshire 5000 equity index rose 7%, or \$69 million, in the last quarter. However, the value of domestic equity holdings declined by \$171 million in the fiscal year. The EAFE index, which tracks the performance of the International Index Fund, dropped 2% in the quarter and the equities associated with that index declined by \$2 million in the quarter and \$53 million in the fiscal year. Total unrealized gain is now just \$41 million.

Equity securities were distributed by fund as follows:

	<u>6/30/2001</u>
Barclay-Wilshire 5000 Index Fund	86%
International Index Fund	<u>14%</u>
	<u>100%</u>

There were realized net gains of \$95 thousand in the quarter from the sale of fixed income securities. Equity securities are recorded at market value; investments in fixed-income securities are recorded at amortized cost. At June 30, 2001, the market value of the fixed-income portion of the investment portfolio exceeded the carrying value by \$130 million. This is a result of market interest rates being lower than the net interest rates on the held portfolio. The market value of fixed-income investments increases as interest rates decline. Generally, however, fixed maturities (bonds) are held to maturity so that differences between market value and carrying value will not significantly influence management's investment decisions or future investment income or yields.

At June 30, 2001, the investment portfolio consisted of the following (in millions):

	<u>Carrying Value</u>		<u>Market Value</u>		<u>Difference</u>
Corporate fixed income securities	3,524	43%	3,496	42%	28
Mortgages and mortgage backed securities	1,516	18%	1,551	18%	(35)
Common and preferred stocks (at market)	1,172	14%	1,172	14%	0
U.S. Treasury securities and obligations of U.S. government agencies and corporations	1,014	12%	1,129	13%	(115)
Debt securities issued by foreign governments	818	10%	820	10%	(2)
Asset backed securities	147	2%	153	2%	(6)
Money market	<u>116</u>	<u>1%</u>	<u>116</u>	<u>1%</u>	<u>0</u>
	8,307	100%	8,437	100%	(130)

Commitments and Contingencies

Effective July 1, 1992, the Washington State Legislature required the Fund to participate in an assigned risk pool providing workers compensation coverage under the United States Longshore and Harbor Workers' Act. The Fund is obligated to participate 50% in the operating results of the assigned risk pool. This participation is scheduled to continue; state legislation passed in 1997, which extended the Fund participation indefinitely.

The pool has not operated at a loss through March 31, 2001. The Fund would record any estimated loss on an annual basis, subsequent to the audit of the results of operations of the assigned risk pool.

STATE OF WASHINGTON INDUSTRIAL INSURANCE FUND
SUMMARY of FINANCIAL CONDITION
(000's) omitted
UNAUDITED

Assets	<u>6/30/01</u>	<u>3/31/01</u>	<u>6/30/00</u>
Cash and Investments:			
Bonds, at Amortized Cost	\$7,135,293	\$7,188,743	\$7,142,663
Stocks, at Market Value			
(Cost \$1,130,850; 1,096,161; 1,096,161)	\$1,171,896	\$1,104,733	\$1,395,730
Net Unsettled Trades	(\$5)	(\$11,172)	(\$39,909)
Cash	(\$1,460)	(\$478)	(\$955)
Total Cash and Investments	<u>\$8,305,724</u>	<u>\$8,281,826</u>	<u>\$8,497,529</u>
Other Assets:			
Premiums Receivable, Net	\$233,788	\$215,615	\$253,136
Interest Receivable	\$107,885	\$109,396	\$105,686
Land, Buildings and Equipment, Net	\$59,610	\$59,651	\$61,217
Other Assets	\$2,896	\$63	\$2,400
Total Other Assets	<u>\$404,179</u>	<u>\$384,725</u>	<u>\$422,439</u>
Total Assets	<u><u>\$8,709,903</u></u>	<u><u>\$8,666,551</u></u>	<u><u>\$8,919,968</u></u>
 Liabilities and Contingency Reserve			
Liabilities			
Estimated Future Benefits:			
Accident Fund	\$2,843,495	\$2,759,149	\$2,768,824
Medical Aid Fund	\$2,447,619	\$2,512,323	\$2,472,517
Pension Reserve Fund	\$1,548,046	\$1,495,641	\$1,385,963
Total Estimated Future Benefits	<u>\$6,839,160</u>	<u>\$6,767,113</u>	<u>\$6,627,304</u>
Other Liabilities:			
Claims Administration	\$423,953	\$420,208	\$427,398
Retro Rating Adjustments	\$119,977	\$165,851	\$133,074
General Obligation Bonds Payable	\$50,475	\$51,485	\$52,700
Other Accrued Liabilities	\$48,545	\$34,167	\$227,291
Deferred Revenue	\$2,006	\$1,922	\$534
Total Other Liabilities	<u>\$644,956</u>	<u>\$673,633</u>	<u>\$840,997</u>
Total Liabilities	\$7,484,116	\$7,440,746	\$7,468,301
Contingency Reserve	<u>\$1,225,787</u>	<u>\$1,225,805</u>	<u>\$1,451,667</u>
Total Liabilities and Contingency Reserve	<u><u>\$8,709,903</u></u>	<u><u>\$8,666,551</u></u>	<u><u>\$8,919,968</u></u>

This information is from Washington State's Accounting and Financial Reporting System.

STATE OF WASHINGTON INDUSTRIAL INSURANCE FUND
SUMMARY of OPERATIONS and CONTINGENCY RESERVE
(in thousands of dollars)
For 3 months and 12 months ending June 30, 2001,
and 12 months ending June 30,2000
UNAUDITED

	3 months ended 6/30/01	Percent of Net Premium	YEAR ended 6/30/01	Percent of Net Premium	YEAR ended 6/30/00	Percent of Net Premium
Revenues						
Premiums Earned:						
Net Standard Premiums	\$220,863	109%	\$877,061	111%	\$937,473	119%
Retrospective Rating Adjustments	<u>(\$19,092)</u>	<u>-9%</u>	<u>(\$89,811)</u>	<u>-11%</u>	<u>(\$146,909)</u>	<u>-19%</u>
Net Premiums Earned	<u>\$201,771</u>	<u>100%</u>	<u>\$787,250</u>	<u>100%</u>	<u>\$790,564</u>	<u>100%</u>
Net Investment Income	\$128,165	64%	\$512,919	65%	\$503,285	64%
Net Realized Gains (Losses) Fixed Income	\$95	0%	\$36,694	5%	<u>(\$8,195)</u>	-1%
Net Gains (Losses) Equities	\$67,163	33%	<u>(\$223,836)</u>	-28%	\$139,628	18%
Self Insured Pension Contributions	\$27,999	14%	\$49,635	6%	\$35,118	4%
Other Income (Expense, all Dividends as shown)	<u>\$0</u>	<u>0%</u>	<u>\$4,710</u>	<u>1%</u>	<u>(\$200,000)</u>	<u>-25%</u>
Total Revenues	<u>\$425,193</u>	<u>211%</u>	<u>\$1,167,372</u>	<u>148%</u>	<u>\$1,260,400</u>	<u>159%</u>
Expenses						
Benefits Incurred:						
Accident Fund	\$199,501	99%	\$518,835	66%	\$434,613	55%
Medical Aid Fund	\$50,627	25%	\$380,182	48%	\$472,379	60%
Pension Reserve Fund	<u>\$91,708</u>	<u>45%</u>	<u>\$313,521</u>	<u>40%</u>	<u>\$248,685</u>	<u>31%</u>
Total Benefits Incurred	<u>\$341,836</u>	<u>169%</u>	<u>\$1,212,538</u>	<u>154%</u>	<u>\$1,155,677</u>	<u>146%</u>
Administrative Expenses:						
Claims Administration	\$29,586	15%	\$92,394	12%	\$60,603	8%
Underwriting	\$7,374	4%	\$27,491	3%	\$27,378	3%
General Insurance Expense	\$5,681	3%	\$21,465	3%	\$20,055	3%
Other Administrative Expenses	<u>\$51,504</u>	<u>26%</u>	<u>\$58,493</u>	<u>7%</u>	<u>\$39,006</u>	<u>5%</u>
Total Administrative Expenses	<u>\$94,145</u>	<u>47%</u>	<u>\$199,843</u>	<u>25%</u>	<u>\$147,042</u>	<u>19%</u>
Total Expenses	<u>\$435,981</u>	<u>216%</u>	<u>\$1,412,381</u>	<u>179%</u>	<u>\$1,302,719</u>	<u>165%</u>
Net Income	<u>(\$10,788)</u>	<u>-5%</u>	<u>(\$245,009)</u>	<u>-31%</u>	<u>(\$42,319)</u>	<u>-5%</u>
Change in Non-Admitted Assets	<u>\$10,770</u>		<u>\$19,129</u>		<u>(\$6,552)</u>	
Change in Contingency Reserves	<u>(\$18)</u>		<u>(\$225,880)</u>		<u>(\$48,871)</u>	
Contingency Reserve, beginning of period	<u>\$1,225,805</u>		<u>\$1,451,667</u>		<u>\$1,500,538</u>	
Contingency Reserve, end of period	<u>\$1,225,787</u>		<u>\$1,225,787</u>		<u>\$1,451,667</u>	

STATE OF WASHINGTON
INDUSTRIAL INSURANCE FUND
CASH FLOW SUMMARY
(in thousands of dollars)
For the 3 months and 12 months ended JUne 30, 2001
and
12 months ended June 30, 2000
UNAUDITED

	3 months ended 6/30/01	Percent of Net Premium	12 months ended 6/30/01	Percent of Net Premium	12 months ended 6/30/00	Percent of Net Premium
Standard Premiums Collected	\$202,690	141%	\$896,407	108%	\$932,566	112%
Self Insured Pension Contributions Collected	\$5,968	4%	\$39,117	5%	\$29,034	3%
Retrospective Rating Adjustments	(\$64,966)	-45%	(\$102,908)	-12%	(\$125,879)	-15%
Net Premiums Collected	<u>\$143,692</u>	<u>100%</u>	<u>\$832,616</u>	<u>100%</u>	<u>\$835,721</u>	<u>100%</u>
Other Income (Expense)	\$3,642	3%	(\$170,831) *	-21%	\$6,232	1%
Fund Transfers In (Out)	<u>\$2,203</u>	<u>2%</u>	<u>\$9,638</u>	<u>1%</u>	<u>(\$5,601)</u>	<u>-1%</u>
Cash Flow In	<u>\$149,537</u>	<u>104%</u>	<u>\$671,423</u>	<u>81%</u>	<u>\$836,352</u>	<u>100%</u>
Benefits Paid	\$269,789	188%	\$1,000,681	120%	\$934,952	112%
Claims Administration Expense	\$25,840	18%	\$95,839	12%	\$83,071	10%
Premium Administration Expense	\$7,274	5%	\$26,351	3%	\$23,425	3%
General Insurance Expense	\$5,606	4%	\$20,575	2%	\$17,160	2%
Other Administrative Expense	<u>\$12,840</u>	<u>9%</u>	<u>\$41,449</u>	<u>5%</u>	<u>\$35,583</u>	<u>4%</u>
Cash Flow Out	<u>\$321,349</u>	<u>224%</u>	<u>\$1,184,895</u>	<u>142%</u>	<u>\$1,094,191</u>	<u>131%</u>
Operating Cash Flow	(\$171,812)	-120%	(\$513,472)	-62%	(\$257,839)	-31%
Net Investment Income	\$133,048	93%	\$540,734	65%	\$512,919	61%
Temp Fund (Purchases)/Sales	\$0	0%	\$0	0%	\$0	0%
Bond (Purchases)/Sales	\$38,886	27%	(\$26,372)	-3%	(\$269,163)	-32%
Fixed Asset Activity, Net	<u>(\$1,104)</u>	<u>-1%</u>	<u>(\$1,395)</u>	<u>0%</u>	<u>(\$4,355)</u>	<u>-1%</u>
Net Cash Flow	<u>(\$982)</u>	<u>-1%</u>	<u>(\$505)</u>	<u>0%</u>	<u>(\$18,438)</u>	<u>-2%</u>
Beginning Cash	<u>(\$478)</u>		<u>(\$955)</u>		<u>\$17,483</u>	
Ending Cash	<u>(\$1,460)</u>		<u>(\$1,460)</u>		<u>(\$955)</u>	

* Includes cash dividends of \$195M.

The source of this financial information is Washington State's
Accounting and Financial Reporting System.

State of Washington Industrial Insurance Fund

Notes to Financial Information

Note A - Summary of Significant Accounting Policies

The State of Washington prepares a Comprehensive Annual Financial Report (CAFR) which includes all funds and account groups of the State and which is in accordance with generally accepted accounting principles (GAAP). The financial activities of the Labor and Industries workers' compensation programs are included in the CAFR.

The accompanying financial information uses "statutory" accounting principles, as would be required of a casualty insurance enterprise when reporting its financial condition to insurance regulators.

Under statutory accounting principles, certain assets (principally receivables which are greater than ninety days past due and office furniture and equipment) are charged against the contingency reserve. Under GAAP, such assets would be recorded on the balance sheet as assets, less valuation allowances or accumulated depreciation.

Bonds are stated at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to investment income. Under GAAP, some or all of the fixed income securities would be stated at market value. Gains or losses on disposition are based on net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Equity securities are stated at market value. Changes in unrealized appreciation or depreciation on equity securities are reflected separately in the income statement.

The Supplemental Pension and Second Injury Funds (See Note C) were not included in these statements because the primary purpose of these statements is to present the financial condition and results of operations of those funds required to maintain actuarial solvency as a basis for premium rates.

Note B - Description of the Industrial Insurance Fund

The State of Washington, through Title 51 RCW, requires employers to secure payment of benefits for job-related injuries and diseases either by paying insurance premiums to the Workers' Compensation Fund or by self-insuring. Direct private insurance is not authorized, although self-insurers are permitted to reinsure up to 80 percent of their obligations.

State of Washington Industrial Insurance Fund

Notes to Financial Information

The statutes provide five benefit funds to make compensation payments to injured employees for various losses. The Accident, Medical Aid, and Pension Reserve Benefit Funds are required to be self-sustaining by insurance premiums. These financial statements report on the financial condition and results of operations of these funds.

The Accident Fund pays compensation directly to injured employees for lost wages during temporary disability, for permanent partial disability awards, and awards pensions to survivors of fatally injured workers and to workers adjudged to be permanently and totally disabled. Claim liabilities are discounted to their present value, as reported in these financial statements, based upon a 4.0% interest rate assumption. Revenues for this fund are provided by employer-paid premiums, calculated on the basis of hours worked. Employers may elect to be retrospectively rated. All retrospective premium adjustments are financed entirely through the Accident Fund. The adjustment calculation considers both Accident Fund and Medical Aid Fund experience and premiums together, however, no retrospective adjustments are made through the Medical Aid Fund.

The Medical Aid Fund pays for the cost of medical and vocational rehabilitation service to injured workers. Employers are allowed to withhold half of the medical aid premium from employees' wages. Medical reserves are discounted to their present value, as reported in these financial statements, based upon a 4.0% interest rate assumption. Revenues for this fund are provided by equal contributions from employers and employees.

The Pension Reserve Fund pays benefits to all permanently disabled pensioners including disabled employees of self-insured employers. These reserves are discounted based upon a 6.5% interest rate assumption. Funding for these pensions is provided by transfers from the Accident Fund and from self-insurers.

The Accident, Medical Aid and Pension Reserve Funds are required to be maintained on an actuarially solvent basis, except that a cash flow basis is authorized for the components of the Pension Reserve fund when related benefits are guaranteed, with a surety bond, by self-insured employers.

Benefit and claim administration expense liabilities are computed by the Agency's actuaries. These liabilities are reviewed at the end of the fiscal year by independent consulting actuaries. The liabilities are estimated future claim and claim administration expense payments for injuries occurring on or before the balance sheet date on a discounted basis. Future premium income is not offset against claim liabilities, as the claims liabilities arise from coverage periods for which premiums have, in general, already been fully earned. The obligation to pay claim and claim administration expense liabilities is not contingent upon any future premium for future coverage periods.

State of Washington Industrial Insurance Fund

Notes to Financial Information

Note C - Other Related Funds

The Second Injury Fund is used to pay pension costs on claims where permanent total disability is at least partially caused by a prior injury. It is funded by amounts received from the Accident and Medical Aid Funds for state fund claims, and by self-insured assessments for self-insured claims. An allowance for future second injury benefit payments is contained within the Accident Fund and Medical Aid Fund claim reserves for State Fund claims. Therefore, this fund does not carry any reserves. This fund's operations are not directly accounted for in these financial statements, but second injury claims which it services are accounted for through the Accident and Medical Aid Funds.

The Supplemental Pension Fund provides for supplemental cost-of-living adjustments to injured employees receiving disability payments. However, the enabling statute requires this fund to operate on a current payment basis and is subject to legislative cancellation. No assets are allowed to accumulate for the future servicing of current claims.

Cost-of-living increases are based on the increase in the state average wage during the preceding calendar year and are granted in July. This fund is financed through assessments to self-insurers and State employers; half of the assessment may be deducted from employees' wages. Income, expense, assets, or future claim liabilities related to Supplemental Pension or Second Injury Funds are not included in the attached financial statements.

The Second Injury Fund and the Supplemental Pension Fund are included in the CAFR. Because these funds are not required to maintain actuarial solvency, as the Accident, Medical Aid, and Pension Funds do, they are not included in this financial information.

Note D - Premiums Receivable, Net

All employers in the State of Washington subject to Title 51 of RCW are required to be covered by the Industrial Insurance Fund and pay policy premiums for workers' compensation insurance, except for certain qualifying employers electing to self-insure. Premiums are normally based on individual employers' reported payroll hours and insurance rates based on each employer's risk classification(s) and past experience. In addition to its regular premium plans, the Fund offers a retrospective premium rating plan under which premiums are adjusted annually for up to four years following the plan year based on employers' loss experience. Adjustments to the original premiums are paid to or collected from the associations and employers approximately ten months after the end of each plan year.

State of Washington Industrial Insurance Fund

Notes to Financial Information

Employer premiums are due 30 days following the calendar quarter covered. An allowance for uncollectible premiums is established when the account becomes delinquent.

Note E - Reinsurance

The Agency maintains reinsurance agreements which provide for recovery of ultimate benefit costs on a catastrophic occurrence basis. Current protection is for up to \$375 million in excess of \$25 million. The Agency would be liable to the extent reinsuring companies are unable to meet their treaty obligations. Reinsurance premiums, commissions, expense reimbursements and reserves related to reinsurance ceded are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums ceded to other companies have been reported as a reduction of premium income.

Note F - Estimated Future Benefits

Reserves for unpaid benefits and claims administration expenses in the Accident Fund and Medical Aid Fund are provided based primarily on ratios of paid to date losses for older accident periods. For more recent accident periods, a selection of several common actuarial techniques is used. These estimates are continually under review and, as changes to the liabilities become necessary, such adjustments are reflected in income currently. The estimates are calculated and presented net of all recoveries. Recoveries include overpayments and successful subrogation against third parties. Recoveries may be in the form of cash or deduction against continuing benefits.

The liability for benefits for the Pension Reserve Fund is determined from individual claims transferred to this fund. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided.